memorandum

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CC:WR:CCA:SJ:TL-N-6550-99
LTSilberzweig

date:

to: Examination Division
Attn: Judy Chan, Revenue Agent
(Stop HQ-4102)

from: District Counsel
Central California District

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subject: [redacted]
EIN: [redacted]

This memorandum is written in response to your request for assistance in the above-referenced matter. This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals, recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This advisory opinion is written in response to your request for advice regarding whether a portion of the software license fees paid to [redacted] ("the Taxpayer") upon execution of its license agreements were maintenance fees which were properly included into income in the taxable year following the execution of the agreements. We believe that the Taxpayer correctly allocated [redacted] percent ([redacted]%) of the initial licensing fees to software maintenance income for the reasons set forth below.

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FACTS

The Taxpayer develops, markets and distributes computer and local area network software which it sells to commercial enterprises [redacted]. The software is considered pre-packaged or off-the shelf software because it is mass marketed and not individually developed for each customer. Customers enter into perpetual license agreements which entitle them to: [redacted].

Although customers are only entitled to updates for the one-year period of the license agreement, a significant majority enter into extended maintenance agreements. The extended maintenance agreements also have one-year terms and entitle the customer to receive all updates at no additional cost (other than the flat fee charged for the extended maintenance contracts). Historically, the Taxpayer has issued updates frequently, but never less than quarterly. The Taxpayer claims that the useful life of the initial software is approximately the one-year term of the licensing agreement because the initial software becomes useless as new hardware is developed and/or if errors in previous versions of the software are not corrected.

The Taxpayer has two types of software maintenance income: (1) the portion of the income from the initial licensing agreement allocated to the maintenance fees; and, (2) the annual maintenance fees payable beginning one-year after the customers enter into the perpetual license agreements. The Taxpayer receives payment in advance of (or at the beginning of) the one-year term for both types of software maintenance income. Only the deferral of income from the initial licensing agreements allocated to the maintenance fees, [redacted] percent of the fee the customer paid for entering into the licensing agreements, for the taxable year ended [redacted] is under consideration by the Examination Division; the tax return was filed on [redacted] (pursuant to extensions). The Taxpayer uses the accrual method of accounting and recognizes all of the software maintenance income ratably over the one-year terms of the license agreements. Although the Taxpayer does defer such maintenance income both for its financial accounting and for Federal income tax reporting, the Taxpayer makes annual adjusting entries and does not determine the amount of income to be deferred on either a daily or monthly basis.

The Taxpayer argues that payments under the extended maintenance agreements are for the provision of services to be performed in the future and that Revenue Ruling 71-21, 1971-2 C.B. 549, provides that an accrual method taxpayer may defer the recognition of payments received in one year for services to be rendered before the close of the following year. The Taxpayer also argues that if the updates are considered to be goods or products, section 1.451-5(a) of the regulations permits the Taxpayer to defer recognition of such payments. All income attributable to the licensing of the initial software or telephone consulting is recognized when the software is shipped or electronically delivered.

The Examination Division questions whether the Taxpayer is entitled to allocate a portion of the payments under the initial license agreements to software maintenance income where the agreements do not specifically allocate an amount of the payments to the software maintenance for the one-year period following the execution of the initial license agreement, but merely state, "[redacted]."

ANALYSIS

I.R.C. section 451 provides that the amount of any item of income shall be included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is properly accounted for as of a different period.

An "advance payment" is defined as any amount received by an accrual method taxpayer ***"pursuant to, and to be applied against, an agreement"*** for the ***"sale or other disposition"*** in a future taxable year of ***"goods"*** held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Treas. Reg. § 1.451-5(a)(1). Generally, advance payments must be included in income either: (i) in the tax year of receipt; or, (ii) except as provided in section 1.451-5(c) (relating to the sale of goods properly includable in inventory, or with respect to an agreement such as a gift certificate), (a) in the taxable year in which properly accruable under the taxpayer's method of accounting for tax purposes if such method results in including advance payments in gross receipts no later than the time such advance payments are included in gross receipts for purposes of all of his reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes; or, (b) if the taxpayer's method of accounting for purposes of such reports results in advance payments (or any portion of such payments) being included in gross receipts earlier than for tax purposes, in the taxable year in which includable in gross receipts pursuant to his method of accounting for purposes of such reports. Treas. Reg. § 1.451-5(b)(1).

In contrast to 1.451-5 of the regulations, Revenue Procedure 71-21 provides that "payments received (or amounts due and payable) in one taxable year for ***"services"*** to be performed by the end of the next succeeding taxable year" may be recognized in the following taxable year. The issue herein involves whether the amounts received by the Taxpayer under the initial two-year term of the agreements and under the extended maintenance agreements constitute advance payments for the ***"sale or other disposition"*** in a future tax year of ***"goods"*** held by the Taxpayer for sale in the ordinary course of its trade or business within the meaning of section 1.451-5(a)(1) of the regulations or whether the payments are made for the provision of ***"services"*** pursuant to Revenue Procedure 71-21.

<u>Goods v. Services</u>

Software is defined as "all programs or routines used to cause a computer to perform a desired task or set of tasks, and the documentation required to describe and maintain those programs." Rev. Proc. 69-21, 1969-2 C.B. 303. Generally, the Taxpayer's updates correct errors or small technical glitches in the initial software (or prior updates) and the updates often contain new features. Additionally, the updates may be necessary as a result of a modification of the related computer hardware. Accordingly, like the original software, the updates are programs used to cause a computer to perform a desired task or set of tasks, and thus, fall within the definition of software under Revenue Procedure 69-21.

Generally, computer software is regarded as a "good" for purposes of the Uniform Commercial Code (U.C.C.). See, e.g., Advent Systems Ltd. v. Unisys Corp., 925 F.2d 670 (3d Cir. 1991). A "good" under section 2-105 of the California Commercial Code is defined as "all things (including specially manufactured goods) which are moveable at the time of the identification to the contract for sale ...." See Bartec Industries, Inc. v. United Pacific Co., 976 F.2d 1274, 1277 (9th Cir. 1992). See also Comshare, Inc. v. United States, 27 F.3d 1142 n.2 (6th Cir. 1994). Arguably, the software and the updates constitute goods under the U.C.C.

Applied Communications, Inc. v. Commissioner, T.C. Memo. 1989-469, supports the argument that software mass-marketed to end-users is a "good" within the meaning of section 1.451-5 of the regulations. In Applied Communications, the taxpayer originally developed customized software applications for its customers. Several years later, the taxpayer reoriented its business toward the development and sale of pre-packaged software (as opposed to customized software). The Tax Court held that the cash receipts and disbursements method of accounting did not clearly reflect the income of the taxpayer because the taxpayer's business had changed from a service-oriented business to a product-oriented business when it changed from developing customized software to selling pre-packaged software.

In the instant case, the Taxpayer develops and markets pre-packaged computer software. The Taxpayer does not develop customized software programs for its customers. The updates are also pre-packaged rather than individually customized. Based on Applied Communications, the Taxpayer's business is considered a product-oriented business. See RRX Indus. v. Lab-Con Inc., 772 F.2d 543, 546 (9th Cir. 1985)(applying the "predominant feature test" in determining that the sale of the software predominated the transaction and that the training of the buyer's employees was incidental to the transaction). See also Kearney v. International Business Machines Corp., 73 F.3d 238, 244 (9th Cir. 1995)(holding where a sale predominates, incidental services provided do not alter the basic transaction); Apollo Group, Inc. v. Avnet, Inc., 58 F.3d 477, 480 (9th Cir. 1995)(holding that "the essence of the agreement" determines the character of a contract).

Although the Taxpayer's creation of the updates may arguably be considered to be a service, we believe that the update itself is a product or a good similar to the original software because the predominant feature of providing the updates is the end-product or the updates themselves; the service aspect does not predominate because the Taxpayer does not customize updates for individual customers. Rather, the Taxpayer provides pre-packaged or off-the-shelf updates. Thus, the Tax Court, applying the predominant feature test in the Ninth Circuit, under the rule of Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd 445 F.2d 985 (10th Cir.), cert. denied, 404 U.S. 940 (1971), would likely hold the provision of the updates to be a contract for the sale of goods and not services.

Sale or Other Disposition

In analyzing whether the Taxpayer's licensing agreements for the initial software constitutes a "sale or other disposition" for purposes of section 1.451-5(a) of the regulations, it is important to consider the reason most software transactions are structured as licenses rather than outright sales. Software is typically licensed to protect certain rights provided by copyright and to protect underlying information utilized in creating the software. In all other respects, most software license transactions resemble sales. See Rodau, Computer Software: Does Article 2 of the Uniform Commercial Code Apply?, 35 Emory L.J. 853, 908 (1986). Since it is impractical, from a marketing perspective, to require purchasers of mass-marketed software to individually negotiate or sign license agreements, software producers insert a license agreement, usually called a shrink-wrap or tear-me-open license, in the software packaging. See Bender, Software Protection: The 1985 Perspective, 7 W. New Eng. L. Rev. 405, 438-40 (1985). Typically, such license agreements state that opening the package or using the software indicates acceptance of the licensing agreement. Licenses of this type make it clear that the software producer retains title and ownership of the software, with the customer only being granted a right to use the software.

Although a license of software is not an actual sale because the software producer retains title to the software, mass-marketed or off-the-shelf software obtained subject to a shrink-wrap or tear-me-open license is most analogous to a sale. In this type of transaction, the software producer has effectively sold the software despite the retention of title since the producer has no realistic expectation of ever getting the software back. See, D. Rice, Computer Products and the Federal Warranty Act, Compute L. Ann. 265 (1985)(mass-marketed software is obtained by consumer for a single fee without return of the software expected). Thus, shrink-wrap or tear-me-open licenses are utilized, not to avoid a sale per se, but rather for purposes of copyright and protection of proprietary information.

In addition to the wide use of licenses to sell software, generally accepted accounting principles (GAAP) recognize the special use of licenses in the transfer of software. The American Institute of Certified Public Accountants (AICPA) Statement of Position 91-1 provides:

> [t]ransfer of rights to software by licenses rather than outright sales protect vendors from unauthorized duplication of their products. However, because the rights transferred under software licenses are substantially the same as those normally expected to be transferred in sales of other kinds of products, the legal distinction between a license and a sale should not cause revenue recognition on software products to differ from revenue recognition on the sale of other kinds of products.

Additionally, we believe the analysis provided in Revenue Ruling 55-540, 1955-2 C.B. 39, supports the Taxpayer's position that licensing software constitutes a "sale or other disposition" within the meaning of section 1.451-5(a) of the regulations. Revenue Ruling 55-540 provides that whether an agreement, which in form is a lease, is in substance a conditional sales contract, depends on the intent of the parties at the time the agreement was executed as evidenced by the terms of the agreement. Specifically, Revenue Ruling 55-540 provides that if the sum of the specified "rentals" over a relatively short part of the expected useful life of the equipment could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges on such amount, and the lessee may continue to use the equipment for an additional period or periods approximating its remaining estimated useful life for relatively nominal or token payments, it may be assumed that the parties have entered into a sales contract even though the passage of title is not expressly provided in the agreement.

Accordingly, for the reasons stated above, we believe that the licensing of the Taxpayer's software, including its provision of the updates, constitutes a "sale or other disposition" within the meaning of 1.451-5(a) of the regulations.

Obligation to Provide Goods

Section 1.451-5(a)(2)(i) of the regulations provides, in relevant part, that the term "agreement" includes a gift certificate that may be redeemed for goods and an agreement that obligates a taxpayer to sell or otherwise dispose of goods in a future tax year which are held by the taxpayer primarily for sale to customers in the ordinary course of its business. The Service could argue that the Taxpayer is not "obligated" to provide goods within the meaning of section 1.451-5(a)(2)(i) of the regulations because the Taxpayer does not guarantee a minimum quantity of software updates under its agreements. However, the Taxpayer has always issued updates very frequently (not less than quarterly). Since the updates correct errors or small technical glitches in the initial software (or prior updates) and the updates often contain new features and computer hardware is constantly being changed, the Taxpayer has a strong argument that it is under an affirmative contractual obligation to deliver updates of its software to its customers. Without the updates, the initial software becomes virtually useless very quickly. Therefore, we believe the Taxpayer has a valid argument that its efforts are consistently directed at producing the updates in order to improve the quality of the software and that it is under a continuous affirmative duty to develop updates of its software.

Therefore, we believe that the licensing agreements constitute an "obligation" within the meaning of section 1.451-5(a)(2)(i) of the regulations.

As stated in the attachment to the Taxpayer's Form 3115 (Application for Change in Accounting Method), the Taxpayer's software maintenance agreements may be considered to be a combination of a service agreement and a product delivery commitment. We believe that even if the Tax Court were to apply the Ninth Circuit's predominant feature test and conclude that the service aspect of the agreements predominates, the Taxpayer would still be entitled to defer the portion of the payments allocable to the updates because Revenue Ruling 71-21 provides that where an accrual method taxpayer, pursuant to an agreement, receives a payment in one taxable year for services required to be performed before the end of the next succeeding taxable year, the taxpayer may include such payment may be included in gross income as the services are performed.

Allocation of Maintenance Fees

Finally, although the perpetual license agreement at issue does not specifically allocate a portion of the initial fees to the annual maintenance fee, the Taxpayer's position is that the fair market value of the updates for the first year following execution of the perpetual license agreements is equal to or greater than [redacted] percent of the fee for the perpetual license agreement. The Examination Division questions whether the Taxpayer's allocation is permitted by section 1.451-5(a)(3) of the regulations, which provides:

> "[i]f a taxpayer (described in paragraph (1) of this paragraph) receives an amount pursuant to, and to be applied against, an agreement that not only obligates the taxpayer to perform the activities described in subparagraph (1)(i) and (ii) of this paragraph, but also obligates the taxpayer to perform services that are not to be performed as an integral part of such activities, such amount will be treated as an "advance payment" (as defined in subparagraph (1) of this paragraph) only to the

> extent such amount is properly allocable to the obligation to perform the activities described in subparagraph (1)(i) and (ii) of this paragraph. The portion of the amount not so allocable will not be considered an "advance payment" to which this section applies."

We believe that the Taxpayer properly allocated [redacted] percent of the fees for the perpetual license agreement to the updates and that the Taxpayer is entitled to defer such amount until the following taxable year despite the fact that such agreement does not specifically state that [redacted] percent of the fee for the perpetual license agreement is allocable to the maintenance fees. However, if the government were to obtain evidence that less than [redacted] percent of the fee for the perpetual license is for the updates, such as the opinion of a qualified expert that the value of the updates for the one-year period following the execution of the perpetual license agreement is less than [redacted] percent of the fair market value of the perpetual license, the government might be able to challenge the Taxpayer's deferral of the maintenance fees. Without [illegible] additional evidence, we believe that the Taxpayer's allocation is "proper" within the meaning of 1.451-5(a)(3).

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[1] We understand that the Examination Division does not intend to hire an expert or to challenge the Taxpayer's assertion that the fair market value of the updates for the one-year period following the execution of the initial licensing agreement is equal to or greater than [redacted] percent of the "domestic license fee" (i.e. the initial fee for the perpetual license agreement).

CONCLUSION

Based on the analysis set forth above, we believe that the Taxpayer's software maintenance income from the perpetual license agreements was earned for the sale of goods for purposes of section 1.451-5 of the regulations and that such income may be recognized ratably over the one-year period beginning when the perpetual license agreements were executed. If you have any questions on this matter, please contact the undersigned at (408) 817-4667.

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By: ______________________________
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